EMPLOYEE PLANS DETERMINATIONS
QUALITY ASSURANCE BULLETIN

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Fail-Safe Provisions

Background

As a result of the corrective amendment procedures contained in Treasury Regulations section 1.401(a)(4)-11(g), many plans now contain a fail-safe provision designed to ensure automatic satisfaction of the nondiscrimination requirement under Internal Revenue Code (IRC) section 401(a)(4), the coverage requirement under IRC section 410(b), and/or the participation requirement under IRC section 401(a) (26) by the plan without the need for a separate or additional plan amendment. Plans are utilizing such a provision in varying degrees due to the complexity of these qualification requirements, anticipated demographic changes, and for the purpose of receiving approval from the Service of a corrective methodology to implement operationally in years in which a problem exists. For these reasons, it is important that the Service develop and apply a consistent position with regard to what requirements an acceptable fail-safe provision must satisfy. In reviewing a fail-safe provision, an agent's primary concerns will be how it affects the plan's satisfaction of the definitely determinable requirement and the anti-cutback rules.

Law

Treasury Regulations section 1.401-1(a)(2) provides that a qualified pension, profit sharing, or stock bonus plan must be a definite written program which is established and maintained by the employer.

Treasury Regulations section 1.401-(b)(1)(i) provides that a pension plan must systematically provide for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement.

Treasury Regulations section 1.401-1(b)(1)(ii) provides that a profit sharing plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants.

IRC section 411(d)(6) provides that the accrued benefit of a participant under a qualified plan may not be decreased as a result of an amendment to the plan.

Treasury regulations section 1.401(a)(4)-11(g) provides that where certain rules set forth in such section are satisfied, a corrective amendment adopted after the end of a plan year will be treated as adopted and effective as of the first day of such plan year enabling such plan to satisfy IRC section 401(a). Such regulation section provides that this retroactive correction is in addition to the rules of IRC section 401(b) and is limited to the correction of qualification requirements under IRC sections 401(a)(4), 401 (a) (26), and 410(b).

Conclusion/Guidance

In order for a fail-safe provision to satisfy the definitely determinable requirements and the anti-cutback rules, the following criteria must be met:

1. A fail-safe provision cannot give the employer discretion in determining whether the provisions require additional allocations or accruals. In other words, an employer cannot have discretion over which test it will utilize to satisfy the nondiscrimination and/or coverage requirements. To satisfy this requirement, the test (e.g., the average benefit test for coverage or the general test for nondiscrimination) which will be used to satisfy coverage an/or nondiscrimination must be specified along with the methods or optional rules (e.g., cross-testing) which will be used in running the test. The test and any optional rules cannot be incorporated by reference. In addition, any definitions of terms necessary in running the test and the optional rules utilized for the test must be set forth.
2. The plan language must assure that a participant's rights under the fail-safe provision are fixed as of the last day of the relevant plan year. No other part of the plan may override these rights or take them away.
3. A fail-safe provision cannot give the employer discretion over which employees receive additional allocations or accruals. It must be known from the terms of the provision which employees will receive the additional allocations or accruals.
4. A fail-safe provision must provide a formula for the additional allocations or accruals, keeping in mind IRC section 411(d)(6). Under Treasury Regulations section 1.401(a)(4)-11(g)(3)(ii), a fail-safe provision cannot reduce a participant's previous accrual or allocation for a plan year. This would include the reduction of a highly compensated employee's previous allocation or accrual. For example, a fail-safe provision implemented by a defined contribution plan after the end of the plan year could not provide for the re-allocation of a contribution so that the added employees share in such contribution. Sometimes it may not be necessary for a fail-safe to provide a formula for the additional allocations or accruals. This would be true of a fail-safe which is built into a plan's normal allocation or benefit formula.

A fail-safe provision that does not satisfy the above criteria should be corrected or deleted to satisfy the above requirements. If the employer refuses to correct or delete the provision, an adverse letter should be proposed. It may be helpful to mention to the employer that by deleting the fail-safe provision, the corrective amendment procedures under Treasury Regulations section 1.401(a)(4)-11(g) can be utilized more efficiently. In other words, by deleting the provision, the employer will have the flexibility of deciding which test and optional rules to use in satisfying the nondiscrimination or coverage requirement. The use of a fail-safe provision eliminates this flexibility and may lead to the use of a method in satisfying IRC section 401(a)(4) or 410(b) that is not the most cost effective to the employer and the plan.

Revision to Prior Guidance

EP Technical Guidance Alert FY-98, No.1 is superseded by this Bulletin. Previous guidance required fail-safe provisions to provide that any additional allocations or accruals be completed on or before the fifteenth day of the tenth month after the relevant plan year as required by Treasury Regulations section 1.401(a)(4)-11(g)(3)(iv). This is no longer a requirement for an acceptable fail-safe provision. However, a plan's language cannot be construed as giving more time than that which is allowed by the regulations for treating contributions as having been allocated as of the last day of the plan year.